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Michael D. O'Keefe

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COMMENTS

INCOME TAX ALLOCATION AND DIVIDENDS UNDER THE MODEL BUSINESS CORPORATION ACT

INTRODUCTION

Modern dividend statutes, as exemplified by the Model Business Corporation Act,[1] have incorporated many accounting terms.[2] For aid in the complex process of construing such statutes,[3] the courts and commentators have turned to generally accepted accounting principles.[4] Although accounting principles may be helpful in statutory interpretation, they are not determinative. The accounting attitude toward a transaction must still be correlated with the dividend policies inherent in the statute.

Reference to generally accepted accounting principles raises severe problems in determining precisely what principles are generally accepted and these problems are made even more difficult where the accounting principles involved are in the process of evolution. A prime example of the latter difficulties, the legal implications of which do not appear to have been recognized, relates to the accounting and dividend treatment to be afforded tax effects in transactions reported in one period for accounting purposes and in another for federal income tax purposes.[5] The accounting techniques by which differences between

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[1] ABA-ALI MODEL BUS. CORP. ACT (1964) (hereinafter cited as Model Act).

[2] The definition of "earned surplus" which appears in § 2(*l*) of the Model Act was derived from one which had been promulgated by the American Institute of Certified Public Accountants. Seward, *Earned Surplus—Its Meaning and Use in the Model Business Corporation Act,* 38 VA. L. REV. 435, 436 (1952); Garrett, *Capital and Surplus Under the New Corporation Statutes,* 23 LAW & CONTEMP. PROB. 239, 258 (1958); Hackney, *The Financial Provisions of the Model Business Corp. Act,* 70 HARV. L. REV. 1357, 1366 (1957).

[3] While the term "earned surplus" is defined in § 2(*l*) of the Model Act as including the balance of the corporation's "net profits, income, gains and losses from the date of incorporation", such definition is meaningless unless it can be determined what transactions are included within the scope of those terms.

[4] Hackney, *Accounting Principles in Corporation Law,* 30 LAW & CONTEMP. PROB. 791, 813 (1965); H. BALLANTINE, CORPORATIONS 527-30 (rev. ed. 1946); D. HERWITZ, BUSINESS PLANNING 326 (1966); Kummert, *The Financial Provisions of the New Washington Business Corporation Act (Part II),* 42 WASH. L. REV. 119, 125-27 (1966).

[5] As to the effect of income tax allocation on public utility rate making where it is sometimes referred to as "normalization," see Note, *The Effect on Public-Utility Rate Making of Liberalized Tax Depreciation Under Section* 167, 69 HARV. L. REV. 1096 (1956); Swiren, *Accelerated Depreciation Tax Benefits in Utility Rate Making,* 28 U. CHI. L. REV. 629 (1961).

tax reporting and accounting reporting are reconciled is called income tax allocation.

To illustrate a situation involving income tax allocation, assume that *X* Corporation purchases for $1,000 a machine with a useful life of five years. Assume that for tax purposes *X* Corporation adopts the double declining-balance method of depreciation, but uses the straight-line method for accounting purposes. Also assume that income less expenses other than depreciation and income taxes is $1,000 in each of the next five years. Finally, for simplicity, assume the tax rate for each year to be 50%.

Resulting tax returns:	1	2	3	4	5
Income less expenses	$1,000	$1,000	$1,000	$1,000	$1,000
Less: DDB depreciation[6]	400	240	144	108	108
Taxable income	600	760	856	892	892
Income tax at 50%	$ 300	$ 380	$ 428	$ 446	$ 446

Resulting Financial Statements Without Tax Allocation:

Income less expenses	$1,000	$1,000	$1,000	$1,000	$1,000
Less: Sl depreciation	200	200	200	200	200
Income before taxes	800	800	800	800	800
Tax expense	300	380	428	446	446
Net income	$ 500	$ 420	$ 372	$ 354	$ 354

Resulting Financial Statements With Tax Allocation:

Income less expenses	$1,000	$1,000	$1,000	$1,000	$1,000
Less: SL depreciation	200	200	200	200	200
Income before taxes	800	800	800	800	800
Tax expense:					
Current year	300	380	428	446	446
Deferred taxes	100	20	(28)	(46)	(46)
Total tax expense	400	400	400	400	400
Net income	$ 400	$ 400	$ 400	$ 400	$ 400

The above demonstration illustrates that without income tax allocation,[7] the final income figure is overstated in the first two years and

[6] The illustration presumes that the machine involved has no salvage value. In order to maximize depreciation, the straight line method was used in the fourth and fifth years as allowed by INT. REV. CODE of 1954, § 167(e).

[7] Technically, the techniques demonstrated in the illustration should be called

understated in the last three years. Tax allocation techniques correct this distortion by means of a charge to tax expense in years one and two and a credit to tax expense in years three, four and five; the amount of the charge or credit equals the tax differences resulting from the use of accelerated depreciation for tax purposes rather than straight-line depreciation. Thus, *if* the *X* Corporation in each of the five years

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interperiod income tax allocation, but since this paper purports to deal only with the problems of interperiod income tax allocation, the shorter reference will be used throughout the paper. Interperiod income tax allocation should be contrasted with *intraperiod* income tax allocation. Intraperiod differences result when elements of taxable income are reported for accounting purposes in the statement of retained earnings rather than in the income statement. The allocation of the tax expense for the period between the income statement and the statement of retained earnings in relation to the taxable transactions which are reported in each statement is called intraperiod tax allocation. To illustrate, assume that a corporation has net operating income before taxes in the amount of $200,000 and also that it has suffered a casualty loss during the period in the amount of $100,000. For simplicity, assume an effective tax rate of 50%:

Resulting tax return:		
Net operating income	$200,000	
Less: Casualty loss deduction	(100,000).	
Taxable income	100,000	
Tax due (50%)	50,000	
	With Allocation	Without Allocation
Resulting financial statements:		
Income Statement:		
Net operating income	$200,000	$200,000
Tax expense	100,000	50,000
Net income for period	100,000	150,000
Statement of Retained Earnings:		
Retained earnings, beginning of period	None	None
Net income, this period	$100,000	$150,000
Less: Casualty loss	(100,000)	(100,000)
Add: Tax saving resulting from casualty loss deduction	50,000	
Earned Surplus, end of period	$50,000	$ 50,000

As can be seen from the above illustration, intraperiod tax allocation affects the amount of net income reported for the period, but the ultimate earned surplus or retained earnings figure is unchanged. Thus, under acts such as the Model Act where the dividend fund is computed by reference to the earned surplus figure, intraperiod income tax allocation does not present any problems since the earned surplus figure is identical whether intraperiod income tax allocation is practiced or not.

However, where a dividend statute provides that dividends may be paid from earned surplus *or* current earnings, the problem of which transactions should be reflected in current earnings and what transactions should be reflected in earned surplus arises. There is general agreement among the accountants that as far as intraperiod transactions are concerned, the tax effect of such transactions should be reported in the same manner as the transaction itself is reported. Thus, if the transaction is reported in the earned surplus account rather than the income account, the tax effects of that transaction should also be reported in the earned surplus account. Presumably a court in determining the dividend fund would adhere to the same sensible solution.

deducted for *tax purposes* \$200 straight-line depreciation, the taxes payable to the Government would have been \$400 for each year (\$1,000 income less \$200 depreciation × 50% tax rate = \$400). In year one, this assumed tax of \$400 less the \$300 actually paid results in an adjustment of \$100 for deferred taxes, thus eliminating the distortion caused by the use of accelerated depreciation for tax purposes. The adjustment is reversed in years three, four, and five.

The effect of income tax allocation upon earned surplus[8] is oftentimes very material.[9] This comment will attempt to determine the relationship of income tax allocation to generally accepted accounting principles. Once this determination has been made, the paper will consider whether the results suggested under generally accepted accounting principles satisfy the objectives of dividend statutes using "earned surplus" as a basis for computing the fund available for dividends.

I. Status of Income Tax Allocation as a Generally Accepted Accounting Principle

Generally accepted accounting principles are those which have substantial authoritative support.[10] The sources for determining whether an accounting principle has substantial authoritative support are: (1) practices commonly found in business; (2) requirements and views of stock exchanges and commercial and investment bankers; (3) regula-

[8] Accountants prefer the term "retained earnings." However, the term "earned surplus" is used here since this is the term used by the majority of dividend statutes, including the Model Act.

[9] The total effect of income tax allocation upon the aggregate retained earnings of the Nation's corporations is undoubtedly in the billions of dollars. *See* The Wall Street Journal, July 26, 1967, at 12, col. 4 where a survey of 100 large corporations indicates an effect of almost one billion dollars. The total of the accumulated tax reserves resulting from income tax allocation by natural gas pipeline companies was 304 million dollars on December 31, 1963. Alabama-Tennessee Natural Gas Co. v. Federal Power Comm'n, 359 F.2d 318, 326 (5th Cir. 1966), *cert. denied,* 385 U.S. 847 (1967).

The Balance Sheet of Sears, Roebuck and Company and Consolidated Subsidaries for the fiscal year ended January 31, 1967 contains in its liability section an account for "Deferred Income Taxes" in the amount of \$574,005,000! The Balance Sheet is accompanied by the following footnote:

> For income tax purposes, the Company uses the installment method of reporting its income. Under this method, the tax on the profit from an installment sale is payable when the profit is realized by a collection from the customer or through the sale of the account. However, the Company prepares its consolidated financial statements on the accrual basis wherein the profit on an installment sale is included in income at the time of sale, and the provision for Federal Income taxes is charged against income concurrently.

[10] American Institute of Certified Public Accountants, Disclosure of Departures from Opinions of the Accounting Principles Board, Special Bull. (1964), reprinted in Accounting Principles Board, Status of Accounting Research Bulletins, Opinion No. 6, at appendix A (1965).

tory commissions' uniform systems of accounts and rulings; (4) regulations and accounting releases of the SEC; (5) opinions of practicing and academic certified public accountants; and (6) opinions by the committees of the American Accounting Association and the American Institute of Certified Public Accountants.[11]

Income tax allocation is widely used by accountants.[12] For example, a survey of the annual reports of 600 industrial and commercial corporations indicates that for the year 1964 there appeared 247 instances of deferred income taxes.[13] In 10 instances, the adjustments for the deferred income taxes amounted to more than 50% of the income account.[14]

Although income tax allocation is unquestionably *permitted* by generally accepted accounting principles, there is a divergence of opinion among accountants as to when, if at all, income tax allocation is *required*. The most definitive statements have come from the American Accounting Association, the SEC, and the American Institute of Certified Public Accountants.

The Position of the American Accounting Association.[15] The AAA Committee on Accounting Concepts and Standards takes the position that significant differences between reported and taxable business earnings should be disclosed by means of a footnote, rather than by use of income tax allocation:[16]

> Disclosure is sometimes accomplished by recording the differences as prepayments (given an expectation of future tax savings) or accruals (given the opposing prospect). However, these items do not present the usual characteristics of assets or liabilities; the posible future offsets are often subject to unusual uncertainties; and treatment on an accrual basis is in many cases unduly complicated. Consequently, disclosure by accrual may be more confusing than enlightening and is therefore undesirable.

The Position of the SEC. In 1945 the SEC issued Accounting Series Release No. 53 stating that the amount shown as tax expense on the income statement should reflect only the *actual* taxes believed to be

[11] GRADY, *Inventory of Generally Accepted Accounting Principles for Business Enterprises*, ACCOUNTING RESEARCH STUDY No. 7, at 52-53 (1965).
[12] BLACK, *Interperiod Allocation of Corporate Income Taxes*, ACCOUNTING RESEARCH STUDY No. 9, at 108 (1966).
[13] AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, ACCOUNTING TRENDS AND TECHNIQUES 201, 210 (19th ed. 1965).
[14] *Id.* at 202.
[15] Hereinafter cited as AAA.
[16] AAA, ACCOUNTING AND REPORTING STANDARDS FOR CORPORATE FINANCIAL STATEMENTS 6-7 (1957 revision).

payable currently under the applicable tax laws,[17] thereby preventing the particular company under review from practicing income tax allocation. But this Release apparently was not adhered to by practitioners nor by the SEC itself.[18] In 1960, without referring to Accounting Series Release No. 53, the SEC issued Accounting Series Release No. 85 which requires tax allocation in situations involving accelerated depreciation. The Release indicates it is the Commission's view that recognition of income tax allocation "should be made in *all* cases in which there is a tax reduction resulting from deducting costs for tax purposes at faster rates than for financial statement purposes."[19]

However, in response to criticism that the language "all cases" in the above sentence was too broad, Accounting Series Release No. 86 was issued stating that income tax allocation is not mandatory "beyond the requirements of generally accepted accounting principles."[20] This release is obviously of little help in resolving what generally accepted accounting principles require. It may mean the SEC believes that generally accepted accounting principles require income tax allocation in all situations involving accelerated depreciation but not in all other cases, or that it is not even required in all cases involving accelerated depreciation.[21]

The Position of the American Institute of Certified Public Accountants.[22] The AICPA, as the representative body of the accounting profession, is particularly influential in determining what are generally accepted accounting principles. Opinions of its Accounting Principles Board [hereinafter cited as APB] constitute "substantial authoritative support."[23] However, accounting practices which are not approved by the APB can also have "substantial authoritative support."[24] But

[17] In the Matter of "Charges in Lieu of Taxes"—Statement of the Commission's Opinion Regarding "Charges in Lieu of Income Taxes" and Provisions for Income Taxes in the Profit and Loss Statement, SEC Accounting Series Release No. 53, Nov. 16, 1945.

[18] Johns, *Allocation of Income Taxes,* 106 J. ACCOUNTANCY, Sept. 1958 at 41, 42-43; L. RAPPAPORT, SEC ACCOUNTING PRACTICE AND PROCEDURE 3.35 (2d ed. 1963).

[19] Statement of Administrative Policy Regarding Balance Sheet Treatment of Credit Equivalent to Reduction in Income Taxes, SEC Accounting Series Release No. 85, Feb. 29, 1960 (emphasis added).

[20] Response to Comment on Statement of Administrative Policy regarding Balance Sheet Treatment of Credit Equivalent to Reduction in Income Taxes, SEC Accounting Series Release No. 86, April 12, 1960.

[21] *See* T. KELLER, ACCOUNTING FOR CORPORATE INCOME TAXES 44 (1961).

[22] Hereinafter cited as AICPA.

[23] AICPA, *supra* note 10. The Accounting Principles Board is a committee of the American Institute of Certified Public Accountants organized to advance the written expression of what constitutes generally accepted accounting principles for the guidance of its members and of others. *Report to Council of the Special Committee on Research Program,* 106 J. ACCOUNTANCY, Dec. 1958, at 62.

[24] AICPA, *supra* note 10.

such divergent accounting practices must be disclosed in the auditor's certificate.[25] This disclosure requirement strongly discourages the use of practices not approved by the APB.

While the APB was not created until 1959, earlier Accounting Research Bulletins [hereinafter cited as ARB] issued by the Committee on Accounting Procedure of the AICPA are to have the same authority as APB opinions.[26] The APB has the power to revise or withdraw any bulletins that are deemed to be inappropriate.

Chapter 10, section B of Accounting Research Bulletin 43 provides broad support for the principle of income tax allocation: "Income taxes are an expense that should be allocated, when necessary and practicable, to income and other accounts, as other expenses are allocated."[27] The words "when necessary and practicable" in the statement leave wide discretion as to when it is required. Further, an introductory statement appearing in section B makes the following exception: "The section does not apply where there is a presumption that particular differences between the tax return and the income statement will recur regularly over a comparatively long period of time."[28] In 1954 ARB 44[29] was issued and required tax allocation in situations involving declining balance depreciation, but it carried over the exception of ARB 43 (using slightly different language) as to differences which recur regularly over a comparatively long period of time.

In 1958 ARB 44 was revised and the Institute reversed its position:[30]

> Where material amounts are involved, recognition of deferred income taxes in the general accounts is needed to obtain an equitable matching of costs and revenues and to avoid income distortion *even in those cases in which the payment of taxes is deferred for a relatively long period....*

There is considerable disagreement among accountants as to how the language in ARB 44 (revised) is to be interpreted. The opponents of tax allocation believe that the bulletin applies only to situations in-

[25] AICPA, *supra* note 10. Failure of a member of the AICPA to disclose a material departure is deemed substandard reporting and will subject a member to review by the Practice Review Committee of the AICPA. Most accountants believe there will be few material departures from Accounting Principles Board opinions. *See* Savolie, *The Accounting Principles Board,* 21 FINANCIAL ANALYSTS J., May/June 1965, at 53, 56.

[26] AICPA, *supra* note 10.

[27] AICPA, ACCOUNTING RESEARCH BULL. 43, ch. 10, § B (1961).

[28] *Id.* at ¶ 1.

[29] AICPA, ACCOUNTING RESEARCH BULL. No. 44, ¶ 4 (1954).

[30] AICPA, ACCOUNTING RESEARCH BULL. No. 44 (REVISED), ¶ 7 (1958) (emphasis added).

volving accelerated depreciation, whereas, the proponents of tax allocation believe that ARB 44 (revised) superseded ARB 43 not just as to situations involving accelerated depreciation, but completely with the effect that tax allocation is now required whenever material amounts are involved.

Accounting Research Study No. 9: Interperiod Allocation of Corporate Income Taxes [hereinafter cited as ARS No. 9] was instigated by the APB so that the problem of income tax allocation could be adequately studied and discussed prior to the issuance of a pronouncement by the Board itself.[31] Accounting Research Studies normally are not considered a source of "substantial authoritative support," but are a vehicle for exposure of problems for consideration and experimentation. After a thorough study and discussion of the problems, advantages, and disadvantages of income tax allocation, ARS No. 9 concluded that income tax allocation procedures should be applied comprehensively, even in situations where the differences between the tax return and the income statement are of a recurring nature over relatively long periods of time.[32] The APB, as yet, has not issued a statement, but it is rumored that most of the 20-man APB favor income tax allocation.[33]

The trend of accounting practice, accounting literature, and the official announcements of the SEC and the AICPA point in the direction of applying income tax allocation whenever the amounts involved are material.[34] In view of this trend and the conclusion reached by ARS No. 9 that income tax allocation procedures should be applied comprehensively, it is submitted that, in the future, generally accepted accounting principles will require income tax allocation to be applied comprehensively. In spite of the above, so long as the AAA maintains its position that footnote disclosure is adequate and so long as a number of prominent accountants continue to support this position,[35] there would seem to be substantial authoritative support for the position that income tax allocation is not required in any case.[36] Therefore, one might conclude that computation of "net profits, income, gains

[31] BLACK, *supra* note 12, at Statement of Policy.
[32] *Id.* at 113.
[33] Wall Street Journal, July 26, 1967, at 1, col. 5.
[34] Perry, *Comprehensive Income Tax Allocation,* 121 J. ACCOUNTANCY, Feb. 1966, at 23, 25; Powell, *Accounting Principles and Income—Tax Allocation,* 29 NEW YORK CERTIFIED PUBLIC ACCOUNTANT, Jan. 1959, at 21, 25.
[35] Wall Street Journal, July 26, 1967, at 1, col. 5.
[36] *See* GRADY, *supra* note 11, at 375 where allocation and nonallocation of income taxes are included in a comprehensive list of alternative accounting methods.

and losses from the date of incorporation" under the Model Business Corporation Act at present allows income tax allocation, but does not require it. This conclusion must be examined in relation to the purposes of dividend regulation and the reasons for the accountants' position.[37]

II. Income Tax Allocation and Dividend Law

Historically, dividend regulations have been enacted as a means of insuring the maintenance of a minimum reserve of net assets as a protection to creditors and preferred stockholders.[38] Since shareholders have the protection of limited liability, creditors have been given a measure of protection by the placing of restrictions upon the right of the corporation to distribute its assets in the form of dividends. Early statutes took the approach of limiting distributions to those which did not reduce the net assets of the corporation to less than the amount of capital stock. Many of the more recent statutes, including the Model Act, have placed the emphasis upon earnings, rather than upon asset valuations as a source of dividends.[39] However, the objective is still the protection of creditors and preferred stockholders. In addition to the protection of these interests, the corporate employees and the public as a whole have an interest in requiring that a minimum fund is maintained so that the corporation can continue as a productive unit within society.[40]

A court may face the problems of income tax allocation in determining the net earnings of a corporation under an earned surplus statute such as the Model Act or under a statute providing for "nimble" dividends. Whether or not the objectives of dividend regulation are furthered by income tax allocation seems to depend upon the type of variation involved.

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[37] R. Baker & W. Cary, Cases and Materials on Corporations 1171 (3d ed. unabr. 1959):

> Thus statutory [dividend] policy involves a delicate balancing of a variety of interest groups: namely, common stockholders, preferred stockholders, creditors, corporate management, and society generally. All the objectives should be borne in mind when evaluating or interpreting the applicable statutes.

[38] D. Kehl, Corporate Dividends 14-21 (1941); R. Baker & W. Cary, *supra* note 37, at 1170-71.

[39] For a discussion of the historical focus on balance sheet values and the conclusion that the emphasis today should be upon the correct determination of current income for determination of the dividend fund, even for statutes which have historically used a balance sheet approach, see Hackney, *Accounting Principles in Corporation Law*, 30 Law & Contemp. Prob. 791, 813-23 (1965).

[40] D. Kehl, *supra* note 38, at 20-21.

A. When Taxable Income is Less Than Accounting Income

This situation might occur when an expense item is deducted from taxable income sooner than it is deducted from accounting income (such as accelerated depreciation) or where an income item is included in accounting income earlier than it is included in taxable income (such as installment sale income).

To illustrate, assume an initial investment in par value stock in the amount of $100,000 fully paid which is used to purchase equipment in the amount of $100,000 which has a life of five years. At the end of the five years, the corporation plans to replace the equipment by purchasing a similar piece of equipment. For income tax purposes, double declining-balance depreciation is used, but for accounting purposes, the straight-line method is used. Assume the corporation's income less other expenses for each of the five years involved amounts to $25,000. For purposes of simplicity, assume a tax rate of 50%.[41] To dramatize the effect of income tax allocation on the dividend fund, assume the corporation plans to distribute 100% of its income after taxes.

Resulting tax returns:	1	2	3	4	5
Other income less expenses	$25,000	$25,000	$25,000	$25,000	$25,000
Less depreciation[42]	40,000	24,000	14,400	10,800	10,800
Net income (Loss)	(15,000)	1,000	10,600	14,200	14,200
Loss carry forward		(1,000)	(10,600)	(3,400)	
Taxable income	none	none	none	10,800	14,200
Tax due	none	none	none	5,400	7,100

Resulting Income Statements without tax allocation:

Other income less expenses	$25,000	$25,000	$25,000	$25,000	$25,000
Less depreciation	20,000	20,000	20,000	20,000	20,000
Income before tax	5,000	5,000	5,000	5,000	5,000

[41] Since corporations are subject to normal, surtax, and capital gains rates, which rate is to be used in estimating the deferred income tax?

One obvious possibility is to use the current average effective tax rate for the particular corporation involved. However, since income tax allocation is based upon the premise that *particular* transactions give rise to the future tax liability, it would seem more consistent to compute the deferred tax as the difference between the total tax liability if the particular item in question is included in taxable income, and the total tax liability if the particular item is not included in taxable income. On the other hand, it might be necessary to use an average rate where the corporation's taxable income varies above and below the $25,000 line at which surtax rates begin to apply. *See* BLACK, *supra* note 12, at 79-81.

[42] The illustration presumes that the machine involved has no salvage value. In

Tax expense	none	none	none	5,400	7,100
Profit (Loss)	5,000	5,000	5,000	(400)	(2,100)
Dividends paid	5,000	5,000	5,000	none	none
Earned surplus (deficit)	none	none	none	(400)	(2,100)

Resulting Income Statements with tax allocation:

Other income less expenses	$25,000	$25,000	$25,000	$25,000	$25,000
Less depreciation	20,000	20,000	20,000	20,000	20,000
Income before tax	5,000	5,000	5,000	5,000	5,000
Tax expense	none	none	none	(5,400)	(7,100)
Deferred tax expense[43]	(2,500)	(2,500)	(2,500)	2,900	4,600
Profit (Loss)	2,500	2,500	2,500	2,500	2,500
Dividends paid	2,500	2,500	2,500	2,500	2,500
Earned surplus (deficit)	none	none	none	none	none

The above illustration is useful in showing how failure to use income tax allocation in this type of situation can adversely affect the purposes of dividend regulation. In this particular case, if income tax allocation is not used, $15,000 of dividends will be paid out in the first three years, whereas the entire earnings for the five year period total only $12,500, thus resulting in a dividend distribution which exceeds earned surplus and the dividend fund by $2,500.[44] Perhaps even more serious is the distortion of income which took place over the five year period. In the first three years of operation, one might be easily led to believe

order to maximize depreciation, the straight line method was used in the fourth and fifth years as allowed by INT. REV. CODE of 1954, § 167(e).

[43] A more informative method of showing the tax expense on the income statement would be as follows:

In years in which income tax allocation increased the tax expense:

Income Taxes:	
Payable for the current year	$ none
Add: Tax benefit deferred to future years	2,500.00
Tax expense for period	$2,500.00

In years in which income tax allocation reduced the tax expense:

Income taxes:.	
Payable for the current year	$5,400.00
Less: Tax benefit in prior years deferred to current year	2,900.00
Tax expense for period	$2,500.00

[44] The capital might be considerably more impaired if the effects of price level changes are considered. Today, the identical machine might have a price tag of $125,000 instead of the $100,000 price tag it had five years ago. If the company in our illustration could not raise additional capital, it might be in difficulty.

that the company was "earning" $5,000 a year and that this was its normal rate of return (having "consistently" earned that amount over a three year period), whereas, when the entire five year period is examined, it becomes clear that the normal return was actually only $2,500 per year. Such distortion of income certainly does not give the stockholders and creditors a fair picture of the current earning power of the company, nor does it encourage the maintenance of a sound dividend policy.[45]

The Model Business Corporation Act defines "net assets" as "the amount by which the total assets of a corporation, excluding treasury shares, exceed the total debts of a corporation."[46] It can be argued that the term "debt" was deliberately chosen as a more certain and limited term than "liabilities," and that deferred taxes, although they may be liabilities of a sort, are not "debts" and may not be recorded to reduce the net assets and earned surplus of a corporation.[47]

However, the Model Act, in regulating dividends, emphasizes earnings and not balance sheet valuations.[48] Income tax allocation is concerned with the prevention of distortions in income and expense. The earning of income gives rise to income tax liability. Thus, in order to properly match revenue with expense and thus prevent distortion of income, the tax expense must be recorded in the same period in which the income giving rise to that expense is recorded. If income tax expense is not allocated, simply changing the method of reporting income or expense (voluntarily or involuntarily) will have the result of shifting income from one accounting period to a subsequent accounting period

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[45] *See* Barr, *Financial Reporting for Regulatory Agencies*, 105 J. ACCOUNTANCY, Feb. 1958, at 26, 29-30:

> The improvement in earnings resulting from this practice [not allocating income taxes] has been so large in some of these cases that amendment of the statements to include an additional charge equal to the tax benefit has been required on the grounds that failure to do so would make the statements seriously misleading.

See also Hayes, *Accounting Principles and Investment Analysis*, 30 LAW & CONTEMP. PROB. 752, 766 (1965):

> In fact, the current procedure in determining the effective tax liability [non-allocation] incident to periodic income is so flagrantly misleading that it might conceivably support a charge of substantive deception.

[46] Model Act § 2(i).

[47] *Cf.*, Garret, *Capital and Surplus Under the New Corporation Statutes*, 23 LAW & CONTEMP. PROB. 239, 243 (1958); Kummert, *The Financial Provisions of the New Washington Business Corporation Act*, 42 WASH. L. REV. 119, 133 n.392 (1966).

Cf., Cox v. Leahy, 209 App. Div. 313, 204 N.Y. Supp. 741 (1924), in which the court, in holding that dividends had impaired capital, allowed prepaid insurance to be considered an asset on the ground that it had actual refund value, but would not allow prepaid taxes to be included because they had no immediate value.

[48] Hackney, *Accounting Principles in Corporation Law*, 30 LAW & CONTEMP. PROB. 791, 823 (1965). The emphasis in accounting has also shifted from the Balance Sheet to the Income Statement. Graham, *Some Observations on the Nature*

when there has been no factual change in the operations of the company. Although the amounts appearing in the balance sheet as a result of income tax allocation may not have the normal characteristics of assets and liabilities, they are amounts which have been set aside so that the tax expense appearing in the current period and subsequent periods relates to the income reported in those periods rather than to a tax reporting method which is unrelated to the company's operations.[49]

It might also be argued that the incurring of future taxes is too uncertain to require that the dividend fund be reduced by such taxes. If the corporation involved does not have profits in the future, there can be no allocation of future taxes since there will be none to allocate and thus, income and the dividend fund should not be reduced. But the continued existence of a corporation presupposes profits.[50] Other dividend valuation procedures also presuppose profits, such as valuing assets at book value rather than liquidating value. Thus, there should be no objection to income tax allocation on this basis unless it is clear that losses will be the norm rather than profits.

The last sentence of the American Accounting Association pronouncement states that income tax allocation "may be more confusing than enlightening."[51] There is considerable merit in trying to keep financial statements in a form which is readily understandable, at least by the directors of the corporation who are responsible for seeing that capital is not impaired. But if income tax allocation is necessary for a fair presentation of the financial position of the corporation, it would seem better to "confuse" the directors with a complicated financial statement which fairly presents the financial position of the corporation, than to "enlighten" them with a simple financial statement

of Income, Generally Accepted Accounting Principles, and Financial Reporting, 30 LAW & CONTEMP. PROB. 652, 658-59 (1965).

[49] This approach seems to be assumed by C. ISRAELS, CORPORATE PRACTICE 248-49 (1963). Mr. Israels, in demonstrating how the "strain" upon the dividend fund can be relieved by switching from declining balance to straight line depreciation for reporting purposes, but not for tax purposes, states that in so doing, a "provision for deferred Federal income taxes" must be made. Whether or not such a provision constitutes a liability under the New York dividend statutes is not discussed.

For the view that balance sheet "worth" values *may* play a role under the Model Act, see Gibson, *Surplus, So What?,* 17 BUS. LAW. 476, 487 (1962) and Seward, *Earned Surplus—Its Meaning and Use in the Model Business Corporation Act,* 38 VA. L. REV. 435, 440-41 (1952).

While there may be no obligation in the legal sense, there is authority for the view that present accounting definitions of liabilities are broad enough to include allocated income taxes. Sands, *Deferred Tax Credits Are Liabilities,* 34 ACCOUNTING REVIEW, Oct. 1959, at 584; Moonitz, *The Changing Concepts of Liabilities,* 109 J. ACCOUNTANCY, May 1960, at 42, 45.

[50] GRADY, *supra* note 11, at 28.

[51] AAA, *supra* note 16, at 6-7.

which does not present fairly the financial position of the corporation and upon which reliance must be placed by directors for the paying of dividends. Perhaps most readers of financial statements do not understand all the complexities of accrual accounting, but this does not justify the use of cash basis accounting.[52] The AAA seems to feel that disclosure by footnote alone is appropriate and adequate.[53] However, if the director cannot understand income tax allocation, it is difficult to see how footnote disclosure alone could be more informative than the actual matching of income with the related tax expense within the income statement itself. If it is determined that income tax allocation is required by a dividend statute, the directors presumably would be responsible for taking into consideration the effects of income tax allocation whether those effects were shown by footnote or in the body of the financial statements.[54]

Perhaps the most serious criticism of income tax allocation is the argument that deferred taxes resulting from income tax allocation are "permanently" deferred.[55] If the transactions which give rise to the possibility of income tax allocation continue to occur at the same or at an increasing rate, the maturing of the tax liability previously deferred by tax allocation will be offset by an equal or larger deferred amount in the current period. Thus, it can be argued that income tax allocation should not be practiced in such situations because, while the corporation remains stable or is expanding, the deferred tax is "permanently" deferred or is deferred for such a long period of time as to make its ultimate payment too speculative to provide a basis for reducing the dividend fund.[56]

[52] It can be argued that failure to use income tax allocation is similar to cash basis accounting since the tax expense figure is based upon the tax paid for a particular period rather than the income reported in that period. *See* Miller, *How Much Income Tax Allocation*, 114 J. ACCOUNTANCY, Aug. 1962, at 46, 48.

[53] Some accountants, even though they favor only footnote disclosure, realize the possible adverse effect upon the dividend fund. "I recognize that the cumulative impact on surplus in relation to dividends may require consideration, but I believe that in most cases this is a disclosure matter only." Powell, *Accounting Principles and Income-Tax Allocation*, 29 NEW YORK CERTIFIED PUBLIC ACCOUNTANT, Jan. 1959, at 21, 29.

[54] Under § 43(e) of the Model Act, directors will not be held liable for unlawful dividends if they can show good faith reliance upon financial statements of the corporation stated in a written report by an independent public or certified public accountant to fairly reflect the financial condition of such corporation. But the footnotes are considered an integral part of the financial statements. Some accountants' reports even contain the language "In our opinion, the accompanying financial statements, *together with the notes thereto*, present fairly...." (Emphasis added.) Thus, it would seem that the directors should be required to take footnote information into consideration.

[55] *See* the Wall Street Journal, July 26, 1967, at 12, col. 4.

[56] *See* R. AMORY & C. HARDEE, MATERIAL ON ACCOUNTING 299-301 (3d ed. 1959);

The theory of "permanent" deferral can be illustrated by the following example. Assume a company purchases a machine at the beginning of each year at a cost of $1,000 per machine. Each machine has a useful life of four years and no salvage value. The machines are depreciated on the straight-line basis for accounting purposes and the sum-of-years-digits basis in the tax returns. Assume a tax rate of 50%.

Resulting tax return depreciation:

Year	1	2	3	4	5
Machine No. 1	$ 400	$ 300	$ 200	$ 100	$
Machine No. 2		300	300	200	100
Machine No. 3			400	300	200
Machine No. 4				400	300
Machine No. 5					400
Total	400	700	900	1,000	1,000

Resulting income statement depreciation:

Machine No. 1	250	250	250	250	
Machine No. 2		250	250	250	250
Machine No. 3			250	250	250
Machine No. 4				250	250
Machine No. 5					250
Total	250	500	750	1,000	1,000
Excess of tax deductions over accounting deductions	150	200	150	none	none
Tax effect	75	100	75	none	none
Accumulated deferred taxes	75	175	250	250	250

Thus, in the above example, if the company continues to purchase at least one machine each year, income tax deductions for depreciation

See also Note, *The Effect on Public-Utility Rate Making of Liberalized Tax Depreciation Under Section* 167, 69 HARV. L. REV. 1096, 1102 (1956) and see Alabama-Tennessee Natural Gas Co. v. Federal Power Comm'n, 359 F.2d 318, 328 (5th Cir. 1966), *cert. denied*, 385 U.S. 847 (1967):

> If the industry is stable or expanding, *requiring the utility's continued reinvestment in plant equal to or in excess of plant retirement*, a program of liberalized depreciation produces true tax savings because there is no reduction in the reserve fund.

Contra, Swiren, *Accelerated Depreciation Tax Benefits in Utility Rate Making*, 28 U. CHI. L. REV. 629, 636-39 (1961), and BLACK, *supra* note 12, at 71-72.

and accounting deductions for depreciation will be identical after the fourth year. Thus, it can be argued that the $250 of deferred taxes which were accumulated in the first three years are "permanently" deferred.[57]

But those who would criticize income tax allocation on this basis overlook the mechanics of accrual accounting. The fact that the deferred tax account remains the same size or increases over a period of years does not mean that the deferred tax is not paid, since the amounts in the deferred account rotate. As a tax which was deferred in a prior period becomes due and *is paid,* a new deferred tax resulting from the current period's transactions takes its place. This same phenomenon takes place in many of the balance sheet accounts. In an expanding company, inventories and trade liabilities may appear in ever-increasing amounts in successive balance sheets, but no one would suggest that they need not be recorded for that reason. The opponents of income tax allocation argue that deferred taxes are different in that their payment is considerably more uncertain.[58] But it is submitted that if the rotation effect is considered, the likelihood of the payment of income taxes in the next succeeding period or next few periods can be predicted with nearly as much certainty as the payment of trade liabilities. If in the future, it becomes clear that taxes will not be paid, proper adjustments can be made at that time.

The contention that income tax allocation requires current recognition of what are, in effect, "permanently" deferred taxes rests upon two assumptions: first, that the company involved will continue to remain stable or expand and thus acquisitions of equipment will continue to at least equal retirements; second, that applicable tax law will continue to permit deferrals. Neither of these assumptions is warranted when computing the dividend fund.

The recent enactment of I.R.C. section 167(i)(1) suspended the use of accelerated depreciation in connection with the use of certain prop-

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[57] The example in text is discussed in BLACK, *supra* note 12, at 65-72 where the following conclusion is reached, *id.* at 71:

> This study rejects the indefinite postponement idea because both its premises and its results are foreign to present concepts and practices in accounting for assets, liabilities, revenues, and expenses.

[58] It is sometimes argued that even if the liability for deferred taxes is recorded, it must be discounted since the deferred taxes are in effect an interest free loan by the government. That the liability should be discounted can be logically supported, but the discount period should be only until the tax is paid which is usually a relatively short period. Opponents of income tax allocation would incorrectly base the discount period upon the length of time which an amount appears in the deferred taxes account on the balance sheet. This, of course, is likely to be a very long

erty.[59] A company which has been using accelerated depreciation for tax purposes, but straight line depreciation for accounting purposes, might find itself in the position of paying previously deferred taxes without new deferred taxes to take their place. If income tax allocation had not been used, the tax expense figure in the company's current financial statement might be drastically increased with a corresponding reduction in net income, even though the company's operations and earning capacity remained unchanged.[60]

Further, even though a company may be expanding, such expansion will seldom progress as a mathematical progression, but will reflect peaks and dips just as most other economic activity.[61] Income tax allocation is needed in such situations if the tax expense reported in the financial statements is going to bear any consistent relationship to the income reported in the peak and dip periods. Dividend regulation cannot afford to gamble on the chance that a company's situation will not change in the near future or that it will follow its present practices ad infinitum.[62]

Even if income tax allocation should have little or no effect upon the current period's reported income, the cumulative effect upon the retained earnings account should not be overlooked.[63] If retained earnings have not been reduced by deferred income taxes, directors and stockholders might be lured into a false sense of security which could

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period and would make the present worth of the liability for all practical purposes zero. *See* BLACK, *supra* note 12, at 82-84. For the argument that the liability should not be discounted at all, see T. KELLER, *supra* note 21, at 118.

The Accounting Principles Board has stated that pending further consideration of discounting deferred income taxes and also the broader aspects of discounting in general, deferred taxes should *not* be accounted for on a discounted basis. ACCOUNTING PRINCIPLES BOARD, OMNIBUS OPINION-1966, OPINION No. 10 ¶ 6 (1966).

[59] The use of the double declining balance and the sum of the years digits methods for computing depreciation was suspended, with certain exceptions, on all buildings not eligible for the investment credit where construction, reconstruction or erection begins or is ordered during the period beginning on October 10, 1966 and ending on December 31, 1967. INT. REV. CODE of 1954, § 167 (i)(1).

[60] Another instance which might cause a deferred tax to suddenly become due would be the disposition of an installment sale receivable on which tax had previously been deferred. *See* INT. REV. CODE of 1954, § 453(d).

[61] *See* BLACK, *supra* note 12, at 72.

[62] *See* City of Alton v. Commerce Comm'n, 19 Ill. 2d 76, 165 N.E.2d 513, 522 (1960):

> If for any reason continued investment in utility plant at current levels should cease, or accelerated depreciation be denied, the financial stability of utilities might be jeopardized if some provision had not been made for the increased taxes that would result.

See also Swiren, *supra* note 56, at 640: "The overhanging burden of unfunded deferred taxes imposes an additional risk which must sooner or later reflect itself in the cost of equity, and perhaps even debt financing. . . ."

[63] *See* Swiren, *supra* note 56, at 641.

be wiped out overnight by a change in circumstances or a simple change in the tax laws.[64]

In short, failure to use income tax allocation in situations where taxable income is less than accounting income may lead to distortions in current period income and retained earnings with a corresponding distortion of dividend policy. As long as the possible liability for deferred taxes exists, it is necessary that the Model Act be interpreted as restricting dividends in the amount of the deferred taxes so as to avoid any possible impairment of capital resulting from such payment.

B. When Taxable Income Is Greater Than Accounting Income

This situation might occur when an expense item is deducted from accounting income prior to the time it is deducted on the income tax return (as when organization costs are written off in the accounts as incurred, but are amortized in the tax returns) or when an income item is reported in the tax return prior to the time it is included in accounting income (as where rents and royalties are taxed as collected, but are deferred until earned for accounting purposes).

Income tax allocation in these situations would consist of a credit to the income statement (thus increasing income for the period) and an offsetting charge to the balance sheet in the amount of the tax "prepaid." Accounting Research Study No. 9 and many advocates of tax allocation take the position that although practice to date has centered around only those situations which resulted in credits to the balance sheet for deferred taxes, "prepaid" income tax is equally as important and should be recognized for the same reasons that deferred income taxes are recognized.[65]

To illustrate, assume that $100,000 in prepaid subscriptions has been received and that these subscriptions cover a four year period. Further assume, that for accounting purposes, these subscriptions are recognized as income ratably over the four year period, but for income tax purposes, they must be reported and the tax paid in the year received. Finally, assume a tax rate of 50%.

[64] In allowing taxes to be deferred in certain situations, the Government normally has goals other than making funds generally available for dividends. For instance, one of the principle reasons for the allowing of accelerated depreciation was to aid companies in plant modernization. Pennsylvania Public Utility Comm'n v. Citizens Water Co. of Washington, Pennsylvania, 13 P.U.R. 3d 189, 222 (1955); S. Rep. No. 1622, 83d Cong., 2d Sess. 26 (1954); H. R. Rep. No. 1337, 83d Cong. 2d Sess. 24 (1954).

[65] Black, *supra* note 12, at 73; Sands, *supra* note 49, at 590.

Resulting tax returns:	1	2	3	4
Other income less expenses	$ 25,000	$25,000	$25,000	$25,000
Subscription income	100,000			
Taxable income	$125,000	25,000	25,000	25,000
Tax due	62,500	12,500	12,500	12,500

Resulting Income Statements without tax allocation:				
Other income less expenses	$ 25,000	$25,000	$25,000	$25,000
Subscription income	25,000	25,000	25,000	25,000
Income before taxes	50,000	50,000	50,000	50,000
Tax expense	62,500	12,500	12,500	12,500
Earned surplus (Deficit)	(12,500)	37,500	37,500	37,500

Resulting Income Statements with tax allocation:				
Other income less expenses	$ 25,000	$25,000	$25,000	$25,000
Subscription income	25,000	25,000	25,000	25,000
Income before taxes	50,000	50,000	50,000	50,000
Taxes paid	(62,500)	(12,500)	(12,500)	(12,500)
Deferred Tax Expense	37,500	(12,500)	(12,500)	(12,500)
Earned Surplus (Deficit)	25,000	25,000	25,000	25,000

Income tax allocation is accomplished in the above illustration by considering the tax which was paid in year one over and above the amount that would have been paid had only $25,000 of subscription income been reported for tax purposes in year one as "prepaid." Thus, the tax expense figure in year one is reduced by $37,500 of "prepaid" taxes ($62,500 less $25,000) which are in turn allocated to the next succeeding three years.

It again becomes evident that failure to use income tax allocation results in a considerable distortion of income. Prevention of this distortion and elimination of the unnecessary deficit suggest that the use of income tax allocation in computation of the dividend fund should be encouraged. But there is some reason to be cautious in recognizing such prepaid taxes as a dividend source.

Initially, it must be recognized that the actual cash which the $37,500 of prepaid taxes represents has already been paid to the Government. Thus, if such amount is to be considered as increasing the dividend fund, the cash with which to pay the dividend must be obtained from other liquid assets of the corporation. Should the corporation not have immediately available the liquid assets to meet such a cash drain, it might run afoul of the insolvency tests which appear in the Model Act.[66] In any event it would not be good dividend policy to unduly reduce the working capital of the corporation.

It must also be recognized that the future benefit resulting from the prepaid tax will not result unless the company has taxable income in the future. If the company has no taxable income, there is no tax liability, and if there is no tax liability, there can be no prepaid tax in the income tax allocation sense. If a prepaid tax has been recorded in such a situation, income will have been overstated. Most accountants, and I believe most attorneys, would agree that an overstatement of income is potentially more dangerous than an understatement of income.[67]

The prepaid asset resulting from income tax allocation is somewhat more uncertain than the usual prepaid assets which appear on financial statements. The usual items, such as prepaid insurance and prepaid rent, will benefit future periods so long as there is some productive activity in such future periods. But in order for a prepaid tax item resulting from income tax allocation to be of benefit, not only must there be productive activity in the future periods, but that activity must be profitable.

In view of the uncertainties involved, prepaid taxes resulting from income tax allocation should not be permitted to increase the dividend

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[66] *See* Kummert, *supra* note 4, at 128-32.

[67] The following footnote from the annual report of Servel, Inc. for the year ended October 31, 1956 (as reprinted in Powell, *supra* note 34, at 26-27) is a good illustration of the danger involved in recording a "prepaid tax":

> It has been the policy of the Company to exclude from income all amounts received from the issuance of extended warranty contracts and to treat such amounts as reserves for the subsequent cost of carrying out such commitments.
>
> For Federal income tax purposes, however, the amounts received for warranty contracts are includable in taxable income of the year in which received, whereas the costs incurred in providing warranty services become deductible only when the expenditures are made.
>
> To avoid distortion of its income statements the Company in 1950 adopted the generally accepted accounting practice of deferring as a charge to income of future years the tax effect of the current net increase in the reserves, and in its financial statements applied such deferred tax effect against its warranty reserves.
>
> Because of the losses from operations experienced by the Company in recent years and the effect of the five year loss carry-forward provisions of the Internal Revenue Code, the Company has re-examined its accounting policy of deferring such income tax effects and has concluded that such policy is no longer appropriate under the presently existing conditions. Accordingly, such policy has been discontinued and the amounts deferred in prior years, aggregating $1,439,800, have been charged to deficit account, with a resulting increase of an equivalent amount in the warranty reserves.

fund unless (1) there is currently cash available with which to pay the dividend and (2) there is convincing evidence that taxes will be incurred in the periods to which the prepaid taxes apply and against which they can be offset.[68] Perhaps directors could be given the burden of showing that the issuance of a dividend upon the basis of such a prepaid tax item was reasonable.

If a situation occurs where both "prepaid taxes" and "deferred taxes payable" exist at the same time as a result of income tax allocation, it would be proper to record the prepaid taxes at least to the extent of the deferred taxes payable since both are based on the same presumption—that is, taxable income occurring in the future. If there is taxable income in the future, both the liability for the deferred taxes and the benefit from the prepaid taxes will occur. If there is no taxable income in the future, the liability will not materialize, nor will the benefit from the prepaid tax. Thus, it would be inconsistent to record one, but not the other. However, if the deferred taxes payable are greater than the prepaid taxes, it will be necessary to recognize the excess, since different criteria are used for determining their existence. A deferred tax liability is recorded if there is *any* expectation of future taxable income, whereas, prepaid taxes should be recorded *only* when the expectation of future taxable income is very certain.[69]

C. Net Operating Losses

The carryback and carryforward of net operating losses under Internal Revenue Code section 172 presents problems in the area of income tax allocation similar to those discussed above in relation to prepaid taxes. Under present law, net operating losses can affect a nine year span—the year in which the loss occurs, a carryback to the three preceding years, and a carryforward to the next five succeeding years.[70] Under present accounting practice, the tax benefit resulting from a loss carryback is recorded in the year of the loss, but a tax benefit resulting from a loss carryforward is not recorded until the loss is actually carried forward and applied to a future year's income.[71]

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[68] Whether or not there is convincing evidence that profits and the corresponding taxes will be incurred in the future is of course a matter of business judgment. The factors which a businessman would consider, and presumably a court reviewing the reasonableness of such decision, are the earnings history of the particular corporation involved, the stability of its product, and the general prospects for the industry and the economy as a whole.

[69] BLACK, *supra* note 12, at 113; DeFliese, *New Study Examines Problems of Allocating Income Taxes Between Periods,* 25 J. TAXATION 261 (1966).

[70] INT. REV. CODE of 1954 § 172(b)(1).

[71] AICPA, ACCOUNTING RESEARCH BULL. No. 43, at 91 (1953).

The difference in treatment stems from the fact that the benefit from a loss carryback is realized immediately, whereas the benefit from a loss carryforward is dependent upon the earning of taxable income within the five year carryforward period. Thus, the recording of a tax benefit in the year of the occurrence of the loss resulting from the possible carry forward of that loss is subject to the same hazards involved in recording prepaid taxes. The basing of a dividend upon the unrealized benefit of a loss carryforward would be even more precarious because the earning of income in the future is even more uncertain when a substantial loss has been currently incurred. However, the recording of such a benefit might be justified where the loss is caused by an isolated event or where the company has a good earnings history and the possibility of a recurrence of the loss is very remote.

When a net operating loss carryforward exists and at the same time there is recorded on the books a deferred income tax liability which is scheduled to accrue within the succeeding five year period, it would be permissible, as in the case of prepaid taxes, to offset the two even though the expectation of future taxable income is not sufficiently certain to justify recording the tax benefit in and of itself.[72]

In summary, generally accepted accounting principles permit income tax allocation, but probably do not as yet require its use. Failure to use income tax allocation in situations involving deferred taxes may distort current period income and retained earnings and thus lead to unsound dividend policy. Over the long run, this could impair capital—a result contrary both to the dividend policy of the Model Business Corporation Act and to sound business practices.

Use of income tax allocation to record "prepaid" taxes results in a recognition of present income, the actual realization of which is dependent upon profitable business activity in future periods. If dividends are paid upon the basis of this recognition and the expected profitable activity does not materialize, the result again could be an impairment of capital.

The overriding policy of the Model Act's dividend provisions is the prevention of capital impairment. Generally accepted accounting principles may be useful tools for interpretation, but should not be allowed to override the policy of the Act. The Model Act should be interpreted to restrict accounting practices which may lead to capital impairment.

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[72] The several combinations that can occur between deferred income taxes, prepaid income taxes, and tax benefits resulting from net operating loss carryforwards are discussed in Black, *supra* note 12, at 91-106.

In situations where taxable income is less than accounting income, tax allocation to record deferred taxes should not merely be permitted by the Model Act but also required. When taxable income is greater than accounting income, directors should be allowed to base dividends upon recognition of "prepaid" taxes only when there is cash available to pay the dividend, and convincing evidence that future taxes will be incurred against which the prepaid taxes can be applied. Were generally accepted accounting principles to require these accounting procedures rather than merely permit them, accounting practices would complement the sound dividend policy expressed in the Model Business Corporation Act.

*Michael D. O'Keefe**

* B.A., 1957, Univ. of Wash.; LL.B., 1967, Univ. of Wash.; Certified Public Accountant; Assistant Professor of Law, Willamette Univ. Law School.